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June 30, 2005

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regs.comments@occ.treas.gov
Attn: Docket No. 05-08

Mr. Robert E. Feldman
Executive Secretary
Attn: Comments
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Comments@FDIC.gov

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
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Washington, DC 20551
regs.comments@federalreserve.gov
Attn: Docket No. OP-1227

RE: Interagency Proposal on the Classification of Commercial Credit Exposures

Ladies and Gentleman:

The PNC Financial Services Group, Inc. ("PNC"), and its principal subsidiary bank, PNC Bank, National Association ("PNC Bank"), both of Pittsburgh, Pennsylvania, are pleased to respond to the request for comments on proposed changes to the supervisory framework for classification of commercial credit exposures, 70 Fed. Reg. 15681 (March 28, 2005) ("Interagency Proposal"). PNC is one of the largest diversified financial organizations in the United States, with approximately $83.4 billion in total assets as of March 31, 2005. Its major businesses include community banking, corporate banking, real estate finance, asset-based lending, wealth management, and global fund processing services. PNC Bank has branches in the District of Columbia, Florida, Indiana, Kentucky, Maryland, New Jersey, Ohio, Pennsylvania and Virginia. PNC also has one other bank subsidiary, PNC Bank, Delaware, Wilmington, Delaware, which has branches in Delaware.

PNC would like to commend the regulators for their work toward a more fair and consistent approach to rating commercial credit. In particular, the establishment of a two-dimensional rating system represents a clear advance over current established classification guidelines. Despite these favorable developments, there are several significant aspects of the Interagency Proposal that we believe need to be improved prior to finalization. We believe that these modifications will be critical to align the Interagency Proposal with emerging best practices and to further its acceptance with industry practitioners.

Summary

Alignment of Rating System to Expected Loss ("EL") — As numerous institutions begin instituting two-dimensional rating systems based on probability of default ("PD") and loss given default ("LGD"), internal reporting, account management and profitability is becoming much more explicitly focused on EL and its components. On the following pages we detail how a purely EL based system could be aligned with the classification of commercial credit exposures.

Alignment of Rating System to New Basel Capital Accord ("Basel II") — It is likely that a number of institutions will become Basel Advanced Internal Ratings Based ("BAIRB") banks over the coming decade. Therefore, regulatory ratings systems should be largely aligned with emerging best practices as defined by Basel II.

Use of Split Ratings — We believe that the Interagency Proposal provides incentives to split rate a borrower's various facilities in order to keep them from being classified. We would prefer a methodology that evaluates each facility as a whole.

Cost of Implementing — While it is likely that the Interagency Proposal could be implemented at PNC, there would certainly be significant incremental and redundant costs to doing so. Additionally, the Interagency Proposal would force many banks to maintain at least two separate rating systems (BAIRB qualified and the Interagency Proposal) that are only marginally different.

We also have other suggestions and questions relating to the alignment of the Interagency Proposal with the proposed SNC Modernization (OCC 2004-07), including the treatment of guarantors and the treatment of asset based lending facilities.

Overall, we are concerned that there needs to be further alignment between the U.S. regulatory Classification of Commercial Credits and Basel II. Without this alignment, many banks currently considering opting for BAIRB status may find the cost of supporting both proposals prohibitive. As complying with U.S. regulatory standards is not optional, banks will not be able to pursue industry best practices. Additionally, all proposed borrower definitions are likely to continue to provide substantial room for interpretation and application of judgment. These proposed definitions also are likely to lead to rating differences between bankers and examiners and among the regulatory agencies.

Discussion

Alignment of Rating System to Expected Loss

One of the primary objectives of a two-dimensional rating system is to produce a more accurate assessment of EL. This objective is accomplished by disaggregating the components of EL into two separate dimensions: probability of default ("PD") and loss given default ("LGD"). Once this disaggregation has occurred, it is easier for credit raters to assess each dimension and it is easier for risk management professionals to validate expectations with actual historical experience. We would propose that the increased granularity afforded by the two dimensional rating be utilized in establishing appropriate means to classify commercial credits. One example of such a framework is shown below. Currently, many banks map Other Assets Especially Mentioned ("OAEM") and Substandard to the rating agencies B3/B- and Caa/CCC, respectively. The EL for OAEM and Substandard would be 3.5 percent and 8 percent, respectively (assuming a 30 percent LGD)[1]. Similarly, Pass, Criticized and Classified classifications could be stated in terms of EL. For example, a credit that is originally assigned a Weak category based on PD could be a Pass, Criticized or Classified loan based on the LGD for that particular transaction.

Interagency Proposal

PD	Marginal 10.00%	Weak 20.00%	Default 100.00%	LGD
	0.00%	0.00%	0.00%	**0.00%**
	0.50%	1.00%	5.00%	**5.00%**
	1.00%	2.00%	10.00%	**10.00%**
EL	1.50%	3.00%	15.00%	**15.00%**
	2.00%	4.00%	20.00%	**20.00%**
	2.50%	5.00%	25.00%	**25.00%**
	3.50%	7.00%	35.00%	**35.00%**
	4.50%	9.00%	45.00%	**45.00%**
	6.50%	13.00%	65.00%	**65.00%**

EL Based

PD	Marginal 10.00%	Weak 20.00%	Default 100.00%	LGD
	0.00%	0.00%	0.00%	**0.00%**
	0.50%	1.00%	5.00%	**5.00%**
	1.00%	2.00%	10.00%	**10.00%**
EL	1.50%	3.00%	15.00%	**15.00%**
	2.00%	4.00%	20.00%	**20.00%**
	2.50%	5.00%	25.00%	**25.00%**
	3.50%	7.00%	35.00%	**35.00%**
	4.50%	9.00%	45.00%	**45.00%**
	6.50%	13.00%	65.00%	**65.00%**

KEY:			
Pass	<	3.50%	
Criticized	<	8.00%	
Classified	<=	100.00%	

1 Ultimately, these EL percentages would be established by regulators but these thresholds were shown for illustrative purposes.

The Interagency Proposal is not consistent with EL. For example, a highly secured (10 percent LGD), Weak PD facility would be Classified while an unsecured (45 percent LGD), Marginal PD facility would be Criticized, even though the EL for the unsecured facility is much higher (4.5 percent vs. 2 percent). Such inequities will arise with any rating scheme that is not EL based.

Alignment of Rating System to Basel II

Basel II incorporates nearly a decade of feedback from industry practitioners and, as such, represents a consensus of industry best practices. Accordingly, we would recommend that the proposed rating methodology align as closely as possible to Basel II. Such alignment will be less burdensome on regulators and less costly to the banking industry with little sacrifice in terms of precision of credit risk information. One such potential area of divergence relates to the definition of loss. While we applaud the Interagency Proposal's reliance on existing data ("…financial institutions may use their impairment analysis for determining the adequacy of their ALLL"), this accounting-based definition of loss is often at odds with the concept of Economic Loss embedded in Basel II.[2]

Additionally, the concept of "Remote Risk of Loss" would potentially be at odds with Basel II as well as general industry practice. We would question whether a 0 percent LGD bucket exists in practice as there are occasionally losses on even the most well secured collateral (e.g., low LTV cash), and there are also economic losses associated with the time value of money. The presence of a loan with a positive spread and an LGD of 0 percent would allow one to construct an infinite return portfolio (at least from an expected loss point of view), which is inconsistent with no-arbitrage pricing theory. Further, it would be impossible to calculate economic capital on a 0 percent LGD using most standard economic capital calculation methodologies. Based on these factors, we would recommend that the rating system be aligned as closely as possible with Basel II.

Other Considerations

The proposed Shared National Credit Program Modernization (OCC 2004-57) suggests enhanced data collection from Basel II mandatory or likely opt-in banks. Among the data proposed for collection are PD and LGD grades. It appears there is a conflict with the PD and LGD grades as recommended by Basel II and the Interagency Proposal.

2 There are several notable differences such as the ALLL's utilization of partial charge-offs, which do not represent true loss, but rather an accounting estimate of potential loss at the time of assessment (which is typically different from the actual cash flow realized). Other differences include discounting methodologies and the inclusion of indirect costs.

PNC has developed and implemented a two-dimensional commercial risk rating system that encompasses a PD and an LGD. PNC views such a system as a risk management best practice tool and enables the bank to pursue the option of BAIRB status. While there is some similarity to the Borrower Rating and Loss Severity dimensions proposed in the Interagency Proposal, the expense of supporting both is likely to be prohibitive without further alignment.

Guarantors: PNC's Observations

At PNC, a guarantor will enhance the LGD rating of a facility, but only rarely will a guarantor enhance the PD rating. The reasons PNC chose to place the value of the guaranty on the LGD rating are twofold:

1. While some guarantors will prevent a borrower from defaulting, other guarantors will wait until the borrower defaults and the bank pursues its rights and remedies under the guaranty agreement. If the bank is forced to pursue its legal rights, collection on this guaranty may take years, or in some cases the bank may be forced to "settle" for an amount less than the original facility amount.

   By enhancing the LGD with the guaranty, the bank is acknowledging that this guaranty may be beneficial in the event of a liquidation. If there is a collateral shortfall, the bank has the legal right to ask the guarantor to pay off the balance of the loan(s).

2. Sometimes a guarantor will only guaranty a specific facility under a borrower's relationship. If the guarantor's rating were substituted for the borrower's rating, as suggested in the Interagency Proposal, then the guarantor's rating would flow to all facilities booked to that particular borrower, even if all the facilities were not guaranteed.

   By enhancing the LGD with the guaranty, the bank is able to identify correctly the riskiness of the actual borrower (via the PD rating), to isolate specific facilities that have been further supported with a personal or corporate guaranty, and to assign those specific facilities a (potentially) better LGD rating based on the guaranty.

   If PNC allowed the guarantor's rating to be substituted for the borrower's rating, several of PNC's loan systems would have to be altered, as our systems currently show only a single borrower rating and then the individual LGD (facility) ratings. Under the Interagency Proposal, a borrower may have more than one rating (in a scenario where all facilities are not guaranteed). Thus, PNC would be forced to alter its loan systems to accommodate different ratings on the same borrower.

Other Comments

The Interagency Proposal states: “When a facility is unconditionally guaranteed, the guarantor’s rating can be substituted for that of the borrower….” At PNC, we do not permit the direct substitution of the guarantor’s rating for the LGD rating. Since a guaranty is a “step removed” from having an actual lien on collateral, and a guaranty can be more difficult to collect in a liquidation/bankruptcy, we believe the strength of the guarantor’s rating should be diminished slightly. At PNC, the allowable LGD substitution is based on the difference between the borrower’s rating and the guarantor’s rating. The smaller the rating difference, the less of an upgrade the LGD is permitted. (PNC assumes if the risk ratings are fairly close, then the risk of the borrower and the guarantor are about the same, so significant LGD enhancements should not be allowed.)

The other questions that arise-s are how the Interagency Proposal will address the following types of guarantees:

1. Limited guarantees.
2. Guarantees from more than one guarantor on a specific loan when the guarantors’ ratings are different but the guarantees are joint and several.
3. Guarantees from more than one guarantor on a specific loan when the guarantors’ ratings are different but the guarantees are several.
4. Make Whole agreements with the guarantors that are in effect for the life of the loan.
5. Unconditional guarantees of collection, but not payment.

Finally, how should the banks address the following types of guarantees, given they are provided by governmental agencies but they are not unconditional:

1. Export-Import Bank (“Exim Bank”) guarantees on Working Capital Guarantee Program loans. (The Exim Bank only guarantees 90 percent of the committed loan amount.)

2. SBA loans – SBA guarantees range from 50 percent to 85 percent of the committed loan amount. SBA Express loans greater than $50,000 are collection guarantees. SBA PLP loans (larger dollar loans) are guarantees of payment, but the SBA will not pay the full amount if the documentation is not in order or if proper procedures have not been followed.

Facility Dimension

Currently for Shared National Credit ("SNC") transactions, institutions are expected to apply consistently qualitatively defined ratings. If Facility Rating loss severity categories (low/moderate/high) were to be determined by "mirroring the institution's allowance for loan and lease losses methodologies," then for SNC facilities whose allowance method would prevail? The Agent Bank or the Participant Bank?

Loss Severity – Under what conditions would letters of credit qualify a facility for Remote and Low Risk of Loss?

Treatment of Asset-Based Lending Facilities

The proposed treatment for Asset Based Lending ("ABL") needs further clarification in the following areas set forth below. Specific examples of what <u>does not</u> qualify, as well as additional examples of those that do qualify, would be useful.

> Other Collateral - It is unclear what is meant by "ABL secured by accounts receivable or <u>other collateral</u> that readily generates sufficient cash to repay the loan." The fundamentals of ABL are to set specific advance rates against a variety of assets that will readily generate sufficient cash to repay a loan. ABL borrowing base structures for revolvers commonly include formula advances secured by accounts receivable <u>and</u> inventory within one facility. In some instances this will also include advances on machinery, equipment and/or real estate. The Interagency Proposal definition for secured by accounts receivable is understood, but what type of "other collateral" qualifies? Does this include inventory and/or machinery and equipment and/or real estate under any circumstances? How would a facility be classified if, for example, receivables qualify but the other assets advanced within the borrowing base do not?
>
> Cash Dominion – Larger commitment ABL transactions are often Shared National Credits. Would cash dominion under the Agent's control qualify for participant banks under the text "the institution must have dominion over the cash"? In addition, cash dominion is often structured with springing cash dominion for higher credit quality ABL transactions. Would springing cash dominion qualify under "the institution must have dominion over the cash"?
>
> Convertibility – Under remote risk of loss and low loss of severity, how is "able to liquidate" defined? Is this defined as within standard ABL "eligible period of days" for accounts receivable or is it based upon an average turnover calculation?

The use of the word “liquidate” is problematic, given that in ABL structures it is common to lend on eligible accounts receivables “up to 90 days” and in some cases lend “up to 180 days,” yet collections in a liquidation scenario would likely exceed these criteria, but would readily generate sufficient cash to repay the loan.

Coverage – Under remote risk of loss and low loss of severity, how is “substantially over-collateralized such that full recovery of the exposure is expected” defined? Is this a function of loan to value or some measure of excess availability (i.e., on average availability that exceeds 10 percent)? Additionally, is this relative to the total commitment or to the borrowing base amount? Finally, what is the basis for determining how “Collateral has been valued within 60 days”? For receivables and/or inventory is this based upon a borrowing base certificate? Would appraisals be required? Or do field exams qualify?

Control – Under remote risk of loss and low loss of severity, how is “collateral is under institution’s control” defined? Is this only a perfected first lien? Would a springing lien on the collateral qualify? Is full cash dominion required?

Cross-Collateralization – Under what circumstances may other loans that are secured by assets and that are cross-collateralized and cross defaulted to a facility that qualifies as Remote Risk of Loss and/or Low Loss of Severity, also be considered Remote Risk of Loss and/or Low Loss of Severity? Conversely, where one facility qualifies for Remote Risk of Loss or Low Loss severity on a stand alone basis, will the same facility continue to qualify for the same classification if cross collateralized and cross defaulted to a facility that is Moderate or High loss severity?

Collateral – In Example 6 of the Interagency Proposal, collateral is described as “investment grade external ratings.” Can the receivables include any non-investment grade eligible receivables and continue to be classified as Remote Risk of Loss? If so, what percentage is acceptable?

Commercial Credit Risk Benchmarks

Borrowing bases – In the paragraph that describes when calculating a financial institution’s criticized and classified assets, it uses the term “borrowing bases.” Is this exclusive to ABL transactions?

Conclusion

PNC is supportive of attempting to transition to a more two-dimensional rating structure. We believe, however, that the Interagency Proposal has several serious shortcomings--primarily, the lack of alignment between the Interagency Proposal and best in class risk management objectives (EL and Basel II). Additionally, we are concerned about the treatment of guaranties, the impact on ABL and the alignment of the Interagency Proposal with the proposed SNC Modernization. Finally, the duplicative rating approaches (internal, SNC, Basel II and the Interagency Proposal) would be costly for institutions to implement and maintain.

Thank you for providing this opportunity to comment. If you have questions about this comment letter, please feel free to contact Alan L. McCrum, 412-762-8895, Director, Portfolio Management, or the undersigned.

Sincerely,

James S. Keller

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